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SUBJECT: IRAQ'S CENTRAL BANK LOWERING POLICY INTEREST RATE  
AS INFLATION SLOWS

¶1. (SBU) The Central Bank of Iraq (CBI) is continuing to drop the policy interest rate as inflation slows, announcing February 22 that as of March 2 its main policy rate would decrease from 19 to 17 percent. The CBI cited the drop in core inflation (which does not include energy prices) from a 30 percent increase in 2006 to "around 10 percent" for January year-on-year. The CBI's decision follows an earlier decrease on January 22 from a 20 to 19 percent; a move the CBI also justified by citing a slowdown in core inflation (12 percent for 2007). The CBI suggested that inflation was decreasing not just as a result of effective monetary policy, but also due to improved security and supply conditions. This action is in line with the Memorandum of Economic and Financial Policies included in the December 2007 Stand By Arrangement (SBA) with the IMF.

¶2. (SBU) The cut is a sign of increased GOI confidence that its policies of the past two years have brought inflation under control. In response to the steady climb of inflation in 2005 and sharp acceleration in 2006, the CBI raised its Policy Rate from 12 to 16 percent in October 2006, and then to 20 percent in December 2006. The CBI also curbed liquidity by gradually appreciating the dinar approximately 17 percent against the dollar starting in September 2006 and continuing through the present. Finally, in August 2007 the CBI increased its required reserve ratio on government deposits from 25 to 75 percent in order to draw up excess liquidity from government deposits in commercial banks.

¶3. (SBU) CBI Governor Sinan Shabibi told EMIN February 23 that the CBI will be watching closely to see if the policy rate cuts lead to an increase in banking activity. He said the CBI stands ready to make further reductions as long as inflation remains moderate.

¶4. (SBU) COMMENT: This further decline of the CBI Policy Rate signals continued loosening of CBI's tight monetary Policy. It is a positive step towards monetary stability, and represents a calibrated monetary policy that could increase the base for domestic lending. Inflation is not quite out of double-digit territory yet because month-on-month (m-o-m) core inflation rates continue to increase (in January 1.8 percent, December 0.7 percent, and November 1.3 percent). Moreover, headline inflation that includes the fuel prices is higher rate: m-o-m in January 3.4 percent, and December 0.8 percent. And it is fuel prices that are a major drain on the average Iraqi's pocketbook. The key indicator on inflation will likely be apparent only during the summer months, as seasonal data indicates a tendency toward increases in the second half of the year. It will be important, therefore, for the CBI to continue a careful and graduated approach to monetary policy in order to prevent a significant reversal. END COMMENT.  
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